



April 30, 2004

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, MA 02110

Re: D.T.E. 03-124

Dear Secretary Cottrell:

I am enclosing for filing the Initial Brief by Massachusetts Electric Company and Nantucket Electric Company.

Thank you very much for your time and attention to this matter.

Very truly yours,

Thomas. G. Robinson

cc: Service List

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COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Petition of Massachusetts Electric Company and Nantucket)
Electric Company for approval of a distribution rate change) DTE 03-124
for calendar year 2004 for exogenous events)

INITIAL BRIEF

by

**MASSACHUSETTS ELECTRIC COMPANY AND
NANTUCKET ELECTRIC COMPANY**

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Introduction

Massachusetts Electric Company and Nantucket Electric Company (together, “Mass. Electric”) commenced this proceeding on November 21, 2003 by filing a distribution rate change for calendar year 2004 designed to reflect cost changes caused by exogenous events occurring after the date of Mass. Electric Rate Settlement approved by the Department in D.T.E. 99-47 (“Rate Settlement”). The proposed rate adjustment for the exogenous events was \$0.00014 per kilowatt-hour effective for usage on and after January 1, 2004, and was designed to recover the net costs associated with the following items that affected Mass. Electric during the year (Ex. MEC-1, p.26):¹

¹ Exhibit MEC-1 is Mass. Electric’s initial filing in this case (Tr. 3/31, p.5). It will be cited by the exhibit number, MEC-1, and the page number shown in the bottom right hand corner of the document. The other Exhibits in the case are Mass. Electric’s responses to the Department and the Attorney General data requests. These will be cited by the request number, and the relevant page or schedule.

The costs shown for Bonus Depreciation benefits are based on an estimate for calendar year 2003, and the remaining cost elements include costs incurred in the twelve months ended September 2003, in a manner consistent with Mass. Electric’s other year-end reconciliations (Exhibit MEC-1, pp. 5-6). For example, the Renewable Portfolio Standards (“RPS”) costs include purchases that were made in 2002 to comply with the 2003 RPS requirement, taking advantage of the Division of Energy Resources’ (“DOER”) regulations allowing early compliance (Exhibit MEC-1, pp. 10, 105; Tr. pp. 78-79). The costs included in

Bonus Depreciation Benefits	(\$2,064,714)
RPS Compliance Costs	2,207,714
Standard Market Design Costs	1,144, 455
Congestion Costs	<u>1,832,992</u>
Total	\$3,119,843

The Department initially noticed and requested comments on the filing by December 17, 2003. Following the comments, the Department on December 29, 2003 denied the rate adjustment without prejudice and subject to further review and investigation. Massachusetts Electric Company, D.T.E. 03-124, p. 4 (2003). On January 9, the Department noticed a further public hearing on the filing, and held that public hearing on January 28, 2004, followed by an evidentiary hearing on March 31, 2004.

During the evidentiary hearing, Mass. Electric supported its filing through the testimony of Theresa M. Burns, Manager of Distribution Rates, Michael D. Laflamme, Manager of Regulatory Support, and Michael H. Hager, Vice President, Energy Supply (Tr. pp. 4-8; Exhibit MEC-1). The Attorney General also appeared in the case, but presented no witnesses. As Mass. Electric's witnesses explained and as we describe below, the rate adjustment proposed in the filing was the result of exogenous events that produced costs, savings, reclassifications, or revenue requirement effects that were not reflected in rates or recovery was not contemplated at the time of the Rate Settlement, are reasonable in amount, and are authorized by Mass. Electric's Rate Settlement.

Accordingly, the Department should approve the proposed rate adjustment.

the filing may be subject to further adjustments and any adjustments will be explained and reconciled in future Exogenous Factor filings.

Mass. Electric's Rate Settlement

Mass. Electric's filing in this proceeding was made pursuant to the Rate Settlement, approved by the Department in Docket D.T.E. 99-47 (Exhibit MEC-1, pp. 5-7). In Section I.C.1 of that Rate Settlement, Mass. Electric agreed to a rate freeze "subject to adjustment for . . . Exogenous Factors occurring after the date of this Settlement which shall accrue beginning 120 days after the date the Department approves this Settlement . . ."² The Exogenous Factors include tax and accounting changes (Section I.C.1.a), legislative or regulatory changes (Section I.C.1.b), and the reclassification of costs "among supply, transmission, and distribution functions in place on the date of the Settlement" (Section I.C.1.d). In the event that an Exogenous Factor occurs, Mass. Electric is required to file for an adjustment by December 1, of the prior calendar year, and following the Department's review and approval, the adjustments would be "collected through a uniform and fully reconciling surcharge or refund factor applied to all kilowatt-hours billed under Mass. Electric and Nantucket retail delivery rates." Section I.C.2.³

² The Rate Settlement is included in Exhibit DTE 1-4 and Department took administrative notice of it in this proceeding (Tr. 3/31, p. 94). The Rate Settlement was filed on November 29, 1999, and the Department approved it on March 14, 2000. All the Exogenous Factors included in Mass. Electric's filing occurred after the date of the Settlement and accrued during the twelve month period beginning in October 2002, more than 120 days after the Department approved the Rate Settlement. The tax change that gave rise to Bonus Depreciation Benefit was first signed into law in March of 2002, and applies to property acquired after September 10, 2001 (Exhibit MEC-1, 54). The DOER regulation that made Mass. Electric subject to the Renewable Portfolio Standard was promulgated on April 26, 2002 and became effective for calendar year 2003 (Exhibit MEC-1, p. 85) and the Generation Information System ("GIS") costs associated with the implementation of the RPS program were filed with FERC on October 26, 2001 with NEPOOL approving the cost allocation on June 21, 2002 (Exhibit MEC-1, p. 81). Finally, the NEPOOL Standard Market Design ("SMD") filing that gave rise to the SMD Costs and Congestion Costs included in the filing was implemented on March 1, 2003 (Exhibit MEC-1, p. 88).

³ As indicated above, Mass. Electric initially proposed that the Exogenous Factor would become effective for usage on and after January 1, 2004 in accordance with Section I.C.2 of the Rate Settlement. As Ms. Burns indicated during the hearing (Tr. 3/31, pp. 58-60), there are several alternatives to adjust the factor given the delay in implementation. The factor could be designed over a shorter period, for the twelve months following the Department's order in this case, or deferred until Mass. Electric's next annual adjustment.

The Exogenous Factors

The Exogenous Factors included in Mass. Electric's filing are triggered by each of the events listed above. As explained below, the Bonus Depreciation Benefits are the result of a change in the Federal Income Tax law, producing an Exogenous Factor under Section I.C.1.a (Exhibit MEC-1, p. 8), the renewable portfolio standard ("RPS") compliance costs stem from a rule change under Section I.C.1.b (Exhibit MEC-1, p. 12), and the Standard Market Design ("SMD") costs and congestion costs are caused by a reclassification of costs under Section I.C.1.d or a rule change under Section I.C.1.b (Exhibit MEC-1, pp. 15-16, n. 4; Exhibit AG-MECO 1-4).

1. Bonus Depreciation Benefits

The first Exogenous Factor was the result of a change in the Federal Income Tax Code, enacted as part of the Job Creation and Worker Assistance Act of 2002. In March of 2002, Section 168 of the Internal Revenue Code was amended to add a new subsection (k) that authorized additional "bonus" tax depreciation on investments made after September 10, 2001 and before September 11, 2004 (Exhibit MEC-1, p. 54). The new section allows businesses to take an additional 30 percent of tax depreciation deduction for qualified property in the first year in addition to the tax deduction already authorized under the Tax Code (Exhibit MEC-1, p.55). In 2003, this law was amended again to increase the "bonus" depreciation from 30 percent to 50 percent for property placed in service after May 5, 2003 through December 31, 2004 (Exhibit MEC-1, p. 56).

Mr. Laflamme explained how the new tax law affects the Company's cost of service. Although this effect does not reduce Mass. Electric's tax liability over the life of

the asset, it reduces the Company's tax liability in the early years, because the tax benefits associated with depreciation are received sooner under the new tax law. Mass. Electric normalizes its taxes, and thus the additional tax depreciation in the new law will increase the deferred taxes on the Company's books and reduce its rate base (Exhibit MEC-1, p. 58). The lower rate base, in turn, reduces the return requirement of the Company, producing a reduction in the revenue requirements from the level contemplated when the Rate Settlement was reached. Mr. Laflamme calculated that the lower return requirement on the reduced rate base to be \$2,064,714 in calendar year 2003 (Exhibit MEC-1, pp. 58-63, 65-70). This amount is based on an estimate and will be reconciled to actual benefits in the filing that the Company makes in the coming year (Exhibit MEC-1, p. 62)

2. RPS Compliance Costs

The second event that triggered an Exogenous Factor was the application of the Renewable Portfolio Standards to Mass. Electric. This event was triggered by the new regulations, 225 CMR 14.00, promulgated by the Division of Energy Resources ("DOER") on April 26, 2002 to implement the renewable energy portfolio standards under G.L. c. 25A, s. 11F. The new regulations expanded the reach of the RPS requirement to include distribution companies providing standard offer and default service.

The RPS requirement was initially adopted by the legislature as part of the Utility Restructuring Act of 1997. 1997 Acts and Resolves of Massachusetts, c. 164, s. 50, pp. 874, 888-89. In that statute, the DOER was required to establish a renewable energy portfolio standard for all "retail electricity suppliers" in Massachusetts. In the same Act,

the legislature amended chapter 164 of the Massachusetts General Laws to define “supplier” as “any supplier of generation service to retail customers, including power marketers, brokers, and marketing affiliates of distribution companies, except no electric company shall be considered a supplier.” 1997 Acts and Resolves of Massachusetts, c. 164, s. 191, p. 913. Based on this definition, Mass. Electric, an “electric company,” as defined under the statute was not subject to the RPS requirement for the service that it was required by statute to provide to customers during the standard offer transition period and for default service, as the provider of last resort obligations.

The DOER, in its implementing regulations, expanded the statutory definition to include distribution companies. The DOER defines “Retail Electricity Supplier” as a “person or entity that sells electrical energy to End-use Customers in Massachusetts, including but not limited to electric utility distribution companies supplying standard offer, default service, or any other successor service to End-use Customers. . .” This expansion in the definition represents a “legislative or regulatory change” that triggers an Exogenous Factor under Section I.C1.b of the Rate Settlement. (Exhibit MEC-1, pp. 9-12, 83-87).

There are two kind of costs associated with compliance with the RPS requirement. First, Mass. Electric participated in the development of NEPOOL’s Generation Information System (“GIS”) that is necessary to account for purchases and assure compliance, and, second, Mass. Electric must purchase the certificates themselves. The costs of both elements were quantified by Mr. Hager in the filing.

The GIS costs are incurred by NEPOOL, and allocated to retail load that is subject to “Attribute Laws” as defined in the cost allocation methodology filed with

FERC (Exhibit MEC-1, pp. 79-81). Massachusetts qualifies as a state with Attribute Laws, because the GIS system is used for environmental disclosure labels⁴ and because the RPS law requires “the inclusion of specified amounts of generation with particular attributes in the generation used in providing electric service to retail customers” (Exhibit MEC-1, pp. 80, 99, definition of Attribute Laws). Although Mass. Electric had incurred \$534,000 of GIS costs in the twelve months ended September 2002, these and the other costs associated with RPS compliance did not exceed the one million dollar threshold in the Rate Settlement, and thus the Company did not include them in its annual retail rate filing in Docket D.T.E. 02-79 (Exhibit MEC-1, p. 11). For the twelve months ended September 2003, however, the DOER’s regulations allowing RPS purchases were operative, and the one million dollar threshold for RPS compliance was met. As a result, Mass. Electric included the \$327,000 that had incurred for GIS during this recent twelve month period in the RPS compliance component of its Exogenous Factor (Exhibit MEC-1, p. 12). Together with the RPS certificate purchases, Mass. Electric’s total costs incurred during the twelve months ended September 2003 were \$2,207,110, well in excess of the million dollar threshold. The GIS costs are reasonable. They are necessary to implement the state’s RPS and environmental disclosure policies, were implemented efficiently on a New England-wide basis, and are subject to review by FERC as part of the NEPOOL tariff.

The second component of RPS compliance costs relate to the certificate purchases that Mass. Electric made to comply with the DOER’s regulations associated with its

⁴ Mass. Electric has begun using GIS data to develop its environmental disclosure labels in the first quarter of 2004. Prior to that time, Mass. Electric relied on the data provided directly from its wholesale suppliers (Exhibit AG-MECO 1-11), and the GIS system was used primarily to generate the certificates necessary to demonstrate compliance with the RPS program requirements.

Standard Offer Service load.⁵ Mass. Electric took a proactive approach to the procurement of RPS certificates. It went to the market early in accordance with a Renewable Energy Portfolio Compliance Plan filed with the Department on November 1, 2002 (Exhibit MEC-1, pp. 85-86, 107-19) and succeeded in holding its procurement costs through September 2003 to about \$1.9 million, producing significant savings over the costs that would have been required had the Company relied on Alternative Compliance Payments to achieve compliance. For example, Mr. Hager estimated that reliance on Alternative Compliance Payments to achieve compliance for Standard Offer Service load would have cost \$7 million in 2003 (Exhibits MEC-1, p. 86; AG-MECO 1-2), approximately twice the \$3.5 million cost that is currently estimated for RPS compliance in 2003 of \$3.5 (Exhibit DTE 2-5). The costs of the procurements were detailed by Mr. Hager (Exhibit MEC-1, p. 105). The costs are reasonable, necessary to comply with the DOER regulations, and appropriate to meet the State's policy to support renewable energy. They are not recovered elsewhere in Mass. Electric's rates.⁶ These RPS compliance costs are properly recovered through the Exogenous Factor in this proceeding.

3. Standard Market Design Costs

In March 2003, the NEPOOL SMD proposal was allowed to become effective by FERC, and NEPOOL was divided into zones, each with a zonal price (Exhibit MEC-1, p.

⁵ The cost of procuring RPS certificates for default service load is included in the price for default service and is therefore not included in the Exogenous Factor filing (Exhibit MEC-1, pp. 10, 86-87). Similarly, Mass. Electric would adjust the Exogenous Factor recovery for the GIS costs associated with default service, if the Department authorizes recovery of the default service related GIS costs through an alternative mechanism (Exhibits MEC-1, p. 12, n. 2; DTE 1-1; see AG-MECO 1-7).

⁶ Mass. Electric had proposed to the Department that the RPS costs associated with Standard Offer Service should be allocated to Standard Offer Service customers several times in the past. (Tr. 3/31, pp. 13-14; Exhibit DTE-1-7; Exhibit MEC-1, p. 107). The Department declined to implement that alternative approach to recovery. As a result, recovery through an Exogenous Factor is appropriate in this case.

90). The congestion costs on the system, which had been borne by transmission and socialized across New England as a whole were transferred to supply and recovered in different regional prices for energy. As a result, Mass. Electric's transmission costs were reduced and the supply costs for Standard Offer Service were increased.⁷ The lower transmission costs were automatically flowed through to customers (see Exhibit AG-MECO 1-3); however, the corresponding increase in supply costs, to the extent that these supply costs can be imposed on Mass. Electric through wholesale standard offer service contracts, have not been recovered from Mass. Electric's customers.

The implementation of the SMD, thus, represents a rule change under Section I.C.1.b of the Rate Settlement to the extent that the new rules "impose new or modify existing obligations" and a reclassification of costs under Section I.C.1.d of the Rate Settlement, which provides that:

Reclassification of Costs. The distribution rates in the Rate Plan are based on the separation of costs among supply, transmission, and distribution functions in place on the date of this Settlement. To the extent that Mass. Electric's service responsibilities change, . . . or the costs and/or revenues now allocated to generation, transmission, or distribution functions by the Department, FERC, NEPOOL, the ISO or any other agency having authority over how such matters are allocated to or away from the distribution function, the Parties agree that appropriate adjustments shall be made to Mass. Electric's distribution rates to reflect the change in cost and/or revenues

As Mr. Hager explained (Exhibits MEC-1, pp. 90-91), most of Mass. Electric's wholesale suppliers of standard offer service have not tried to flow the reallocated costs through to Mass. Electric. Thus, for these contracts, Mass. Electric's customers have received the benefit of reduced transmission costs without any increase in supply costs. Because for these customers Mass. Electric's transmission costs and transmission

⁷ Default service supply costs also increase, but the increased costs are reflected in the bids by default service providers and Mass. Electric's retail prices for default service. As a result, there are no exogenous event costs associated with default service.

revenues both decrease by the same amount, no Exogenous Factor adjustment is necessary. However, to the extent that the reclassification leads to an under-recovery by Mass. Electric of the costs that have been reclassified when the savings have been reflected to customers, then an exogenous adjustment is both appropriate and necessary under the reclassification of costs section of the Rate Settlement.

a. SMD costs billed by the ISO

Four suppliers have disputed their responsibility to pay the additional supply costs under the new SMD rules. In three of these cases, Mass. Electric and the suppliers are in a dispute. In the first case, Mass. Electric and the supplier have agreed to a temporary allocation, subject to later dispute resolution. No charges were billed under this temporary arrangement during the period prior to September 30, 2003, and as a result no costs are included in this filing (Exhibit MEC-1, p. 91). In the second case, the supplier directed the ISO to bill Mass. Electric directly for certain of the reallocated costs (Exhibit MEC-1, pp. 91-92). The ISO billings from the ISO to Mass. Electric for this supplier are detailed on Exhibit MEC-1, p. 121, under the column headed “Supplier 1.” Because Mass. Electric disagrees with the billings, Mass. Electric has deducted an equivalent amount from the supplier’s billings to Mass. Electric, and as a result, these costs are not contributing to the Exogenous Factor filed in this case.⁸ In the third case, Mass. Electric and the supplier have completed one formal dispute resolution, under which Mass. Electric prevailed, but the supplier is continuing to dispute the charges. The unrecovered billings with this supplier for the period ending September 2003 total \$1,180,253 as shown on Exhibit MEC-1, 121, under the column headed “Supplier 2.” Mass. Electric is

⁸ The amounts billed by the ISO to Mass. Electric total \$1,460,666 during the period and the amounts withheld by Mass. Electric are a slightly higher amount of \$1,496,464, producing a slight reduction in the exogenous factor in this case. See AG-RR-1 for a reconciliation and explanation of the differences.

seeking confirmation of the dispute resolution in Superior Court, and if successful will credit any recoveries back through the Exogenous Factor (Exhibit AG-MECO 1-6).

The sum of the billings from the ISO to Mass. Electric that have not otherwise been mitigated is also shown on Exhibit MEC-1, p. 121 as \$1,144,455, which is carried forward to Ms. Burns total of items included in the Exogenous Factor on Exhibit MEC-1, p.26.

b. Congestion costs paid to the fourth supplier

The implementation of the SMD by the ISO has led to an agreement by Mass. Electric to pay one supplier to resolve the issues associated with the implementation of the SMD program (Exhibit MEC-1, p. 93). The circumstances leading to the agreement were reviewed by the Department in Docket D.T.E. 03-67. See Exhibit MEC-1, pp. 123-26 for a copy of Mass. Electric's filing in that proceeding and Exhibit AG-MECO 1-4 for the Department's response to that filing.

In Mass. Electric's filing, the Company requested the Department's approval of the additional costs under the contract in its Standard Offer Adjustment Provision. The unique language in the contract gave the supplier the right to deliver its power to any node in New England rather than to Mass. Electric's customers, potentially requiring Mass. Electric to pay the congestion costs associated with deliveries to its load (Exhibit MEC-1, p. 124). By agreeing to a fixed per kilowatt-hour payment with the supplier and placing the responsibility for delivery on the supplier, Mass. Electric was able to reduce its potential payments to the supplier and allow the supplier, which controlled its generation purchases, to mitigate the congestion costs that the supplier would realize under the new rules. Because Mass. Electric does not control the sources for the

wholesale purchases by its standard offer suppliers in a way that would limit its congestion costs, Mass. Electric had no ability to reduce or mitigate the congestion costs that the supplier could have incurred and passed along to Mass. Electric under the new rules (Exhibit MEC-1, p. 124). As a result of the settlement, Mass. Electric was able to reduce its exposure from \$5.6 to \$8.3 million per year to about \$3.2 million per year (Exhibit MEC-1, p. 93). The exogenous costs that were incurred in the period from March to September 2003 were \$1,832,992, which are included in the design of the Exogenous Factor (Exhibit MEC-1, pp. 26, 128).

These costs are reasonable and appropriate. In the Department's response to Mass. Electric's request for approval for the recovery of the costs under the agreement, the Department found (Exhibit AG-MECO 1-4, p. 4 of DTE letter) that the ISO market rules with regard to transmission costs "changed significantly with the implementation of SMD on March 1, 2003." The Department recognized that (Id at p. 5, footnote omitted):

Congestion costs are no longer allocated to transmission providers based on network load—instead, they are included in the hourly LMPs for each zone. The implementation of SMD changed the treatment of congestion costs in two important ways. Under SMD, congestion costs are (1) localized within load zones, rather than socialized throughout New England, and (2) treated as generation costs, rather than transmission costs.

The Department ultimately concluded that its approval of the contract in Docket D.T.E. 03-67 was premature given that the contract was subject to FERC's jurisdiction and that an "additional factual record is necessary to determine the exact nature of the congestion cost and litigation risks faced by MECO's ratepayers, and thus, whether the proposed amendment is in the public interest" (Id at p. 5), and denied Mass. Electric's request for approval of the amendment to the original contract. However, both of these events have now occurred. The amended contract is on file with FERC pursuant to the supplier's

market based tariff, and the Department has had the opportunity in this proceeding to evaluate fully the congestion costs and litigation risks associated with this agreement. As Mr. Hager testified, these risks were substantial; absent the agreement, Mass. Electric's customers would have incurred approximately \$5.6 to \$8.3 million of congestion costs under the new market rules (Exhibit MEC-1, p. 93). Mass Electric reasonably took steps to mitigate these risks. The Department has already concluded that the SMD regulation which became effective on March 1, 2003 reclassified these costs from transmission to supply. They are not being recovered elsewhere in Mass. Electric's rates. They are appropriately recovered as an Exogenous Factor associated with the reclassification of costs under the Rate Settlement. The Department should so find.

Conclusion

For the reasons stated, the Department should approve Mass. Electric Exogenous Factor filing and allow recovery of the cost produced by the Exogenous Events included in the filing.

Respectfully Submitted,

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Attorneys for Massachusetts Electric
Company and Nantucket Electric Company

April 30, 2004

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Westborough, this 30th day of April, 2004.

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Attorney for Massachusetts Electric
Company and Nantucket Electric Company
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